New Markets Tax Credits

City of Seattle
Office of Economic Development

Lecture Notes

THE NATIONAL DEVELOPMENT COUNCIL™

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Outline of NMTC Presentation

9:30 a.m. to 10:10 a.m.

- Background on the NMTC program
- Basic Investment Structure – Flow of Funds to Project
  - Seattle Investment Fund LLC
  - QEI — Investment to CDE
  - QLICI — Investment to Project

10:20 a.m. to 11:30 a.m.

- Deal Structuring – key considerations
- Hypothetical Investment – detailed breakdown
- Q&A

Background on the New Markets Tax Credit Program

New Markets Tax Credit Program Overview

- In 2000, Congress Passed Legislation Encouraging Investment in Census Tracts Located in Low-Income Communities (LICs)
  - The New Markets Tax Credit (NMTC) program is operated through the Community Development Financial Institution (CDFI) Fund, a division of the U.S. Department of the Treasury (www.cdfifund.gov)

New Markets Tax Credit Program Overview (cont.)

- Designed to spur investment and promote economic development in rural and urban low-income communities

- Provides investors a credit against federal income tax liability for a qualified investment

New Markets Tax Credit Program Overview (cont.)

- Annual Awards of Tax Credit Based upon Congressional Appropriations – $2.5 to $5 Billion Approved through 2009
- Pending Congressional legislation to extend program in 2010 for $5 Billion of Authority

2009 Applicants and Allocations

- 249 CDEs Applied in 2009 Requesting $22.5 Billion; $5 Billion Awarded
  - 99 (or 40 percent) received awards
  - Average award was $50 million
  - Awards ranged from $4 million to $125 million
- In 2009, Seattle Investment Fund LLC, a CDE created by the City of Seattle, received a $40 million NMTC allocation

New Markets Tax Credits Program Overview (cont.)

- Geographically Targeted Tax Credits for Institutions that Invest into LICs
  - To receive NMTCs, the investor must invest through a Community Development Entity (CDE)
  - The CDE is a pass-through entity
  - Primary mission of the CDE must be to benefit LICs

New Markets Tax Credits Program Overview (cont.)

- NMTC Allocations Are Awarded to the CDE — not to the Project
  - Low-Income Housing Tax Credits (LIHTCs) and Rehabilitation Tax Credits (RTCs) are awarded to a project
  - Rehabilitation Tax Credits (Historic Credits) are project-based

Award is based upon a competitive application process

New Markets Tax Credits Program Overview (cont.)

- NMTCs Are Awarded for the Investment into the CDE
  - This investment is known as the Qualified Equity Investment (QEI)
  - NMTC = 39 percent of the QEI over seven years
  - 5.0 percent tax credit for each of the first three years and 6.0 percent tax credit for each of the next four years
  - Credits flow on the date of the QEI investment and each anniversary date thereafter

New Markets Tax Credit Seattle Projects

17th & Jackson Mixed Use Development

New Construction

- 59 Residential Units
- 11,231 SF Commercial Space

Project Cost - $19.7 million
NMTC Portion - $14.5 million

NMTC Equity Generated
$4.36 million
22% of Project Budget

Wing Luke Museum

Rehabilitation

Project Cost - $20.0 million
NMTC Portion - $14.5 million

NMTC Equity Generated
$3.32 million
17% of Project Budget

Bush Hotel – Commercial Portion

Historic Rehabilitation

6 – Story 81,045 SF
26,223 SF – Commercial Portion

Project Cost - $ 9,874,406
NMTC Portion - $ 7,500,000

NMTC Equity Generated
$2,925,000
30% of Project Budget

Historic Tax Credit Equity Generated
$1,013,959
10% of Project Budget

Eligible Projects

- Loans and Investments in Operating Businesses Located in LICs
- Development of Commercial, Industrial and Retail Real Estate in LICs
- Mixed-use Projects Are Okay Where Commercial Income Exceeds 20 percent of the Gross Income of the Property

Eligible Projects (cont.)

- Development of For-sale Housing in LICs
- Loans Purchased from another CDE that have been Made to Eligible Projects in LICs
- Financial Counseling and other Services to Businesses and Residents Located in LICs

Low-Income Communities

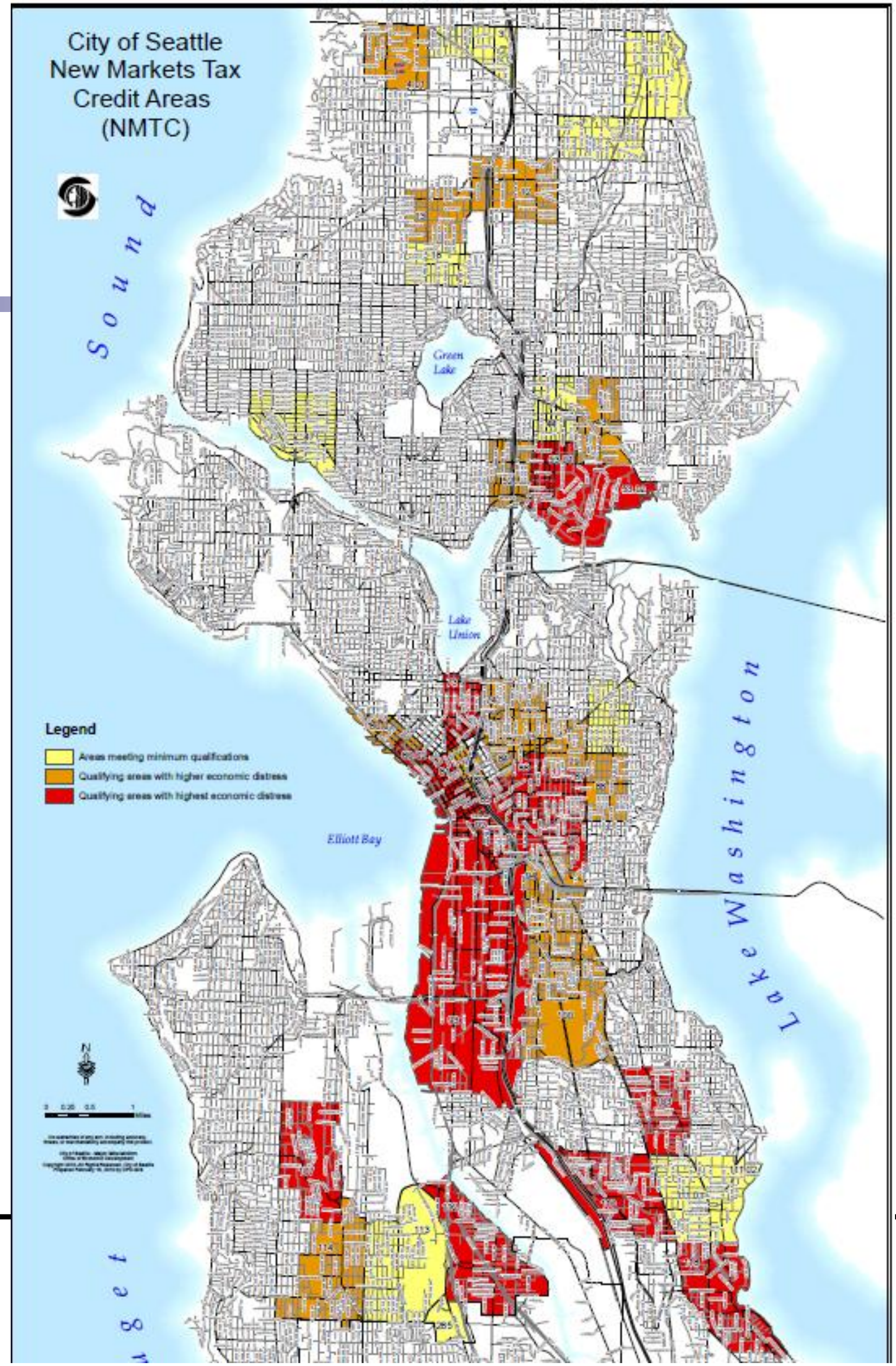
- Census Tracts where
  - Poverty rate exceeds 20 percent, or
  - Median income is below 80 percent of the greater of the statewide median or the metropolitan area median

"Severely Distressed" Criteria

- The QALICB's Census Tract Has the Following Characteristics
  - Poverty rates greater than 30 percent;
  - Median family income does not exceed 60 percent of statewide or metropolitan median family income, whichever is greater;
  - Unemployment rates at least 1.5 times the national average;
  - Census tracts with one of the following; Poverty rate greater than 25 percent; median family does not exceed 70 percent AMI; or unemployment rates at least 1.25 times the national average

SEATTLE NMTC AREAS

- Areas meeting minimum qualifications
- Qualifying areas with higher economic distress
- Qualifying areas with highest economic distress



"Severely Distressed" Criteria (cont.)

- Area designated as distressed by the Appalachian Regional Commission or Delta Regional Authority
- Federally designated Empowerment Zone, Enterprise Community, or Renewal Community;
- SBA designated HUB Zones;
- Designated as Native American or Alaskan Native areas, Hawaiian Homelands, or redevelopment areas by the appropriate Tribal or other authority;
- Colonial area as designated by HUD
- Brownfield's site as defined under 42 USC 6201 (39);
- Encompassed by a HOPE VI redevelopment plan;

"Severely Distressed" Criteria (cont)

- Targeted Populations
- Located in a medically underserved area.
- Non Metropolitan Counties
- Designated for redevelopment by a governmental agency
- FEMA disaster County
- High Migration Rural County
- Businesses certified by the Department of Commerce as eligible for assistance under the Trade Adjustment Assistance for Firms (TAA) Program

- *NOTE: must meet one of the top three or two of the remaining 15 items*

Ineligible Projects

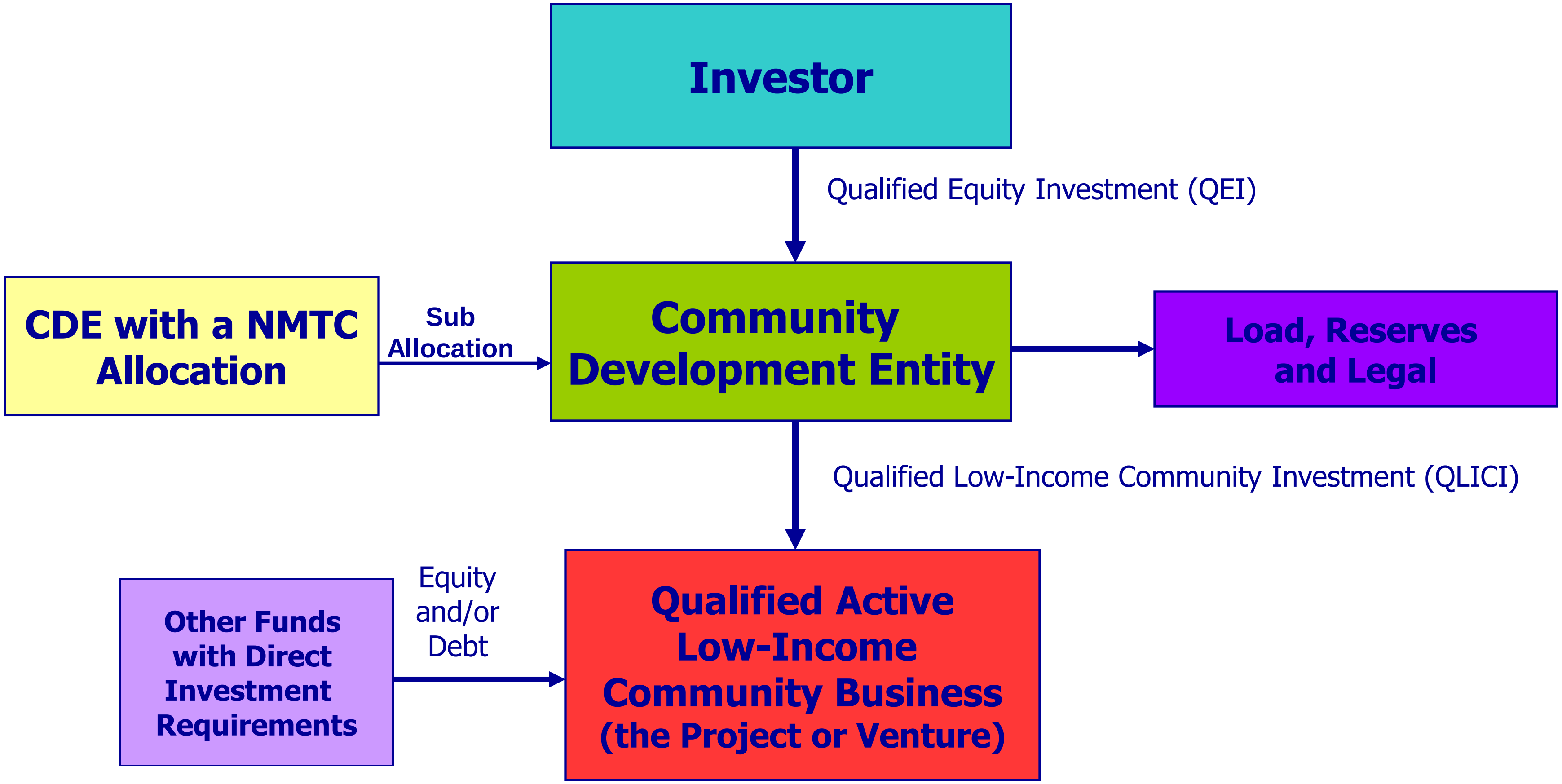
- Investment Real Estate where more than 80 Percent of its Income Is Derived from the Residential Dwelling Units in the Property
- Golf Courses, Country Clubs, Massage Parlors, Hot Tub or Tanning Facilities
- Gambling Facilities
- Farming Businesses
- Stores whose Principal Business Is the Sale of Alcoholic Beverages

Basic Investment Structure

Alphabet Soup

- **CDE** – Community Development Entity
- **QEI** – Qualified Equity Investment
- **QALICB** – Qualified Active Low-Income Community Business
- **QLICI** – Qualified Low-Income Community Investment

NMTC Basic Flow of Funds



Community Development Entity

- What Is It?
  - An organization whose primary mission is to benefit LICs
  - The CDE – not the project – receives the NMTC allocation
  - The CDE must be certified by the Department of the Treasury
  - The CDE must be accountable to the LIC through an advisory group or governing board

Community Development Entity (cont.)

- The CDE is the bridge between the private equity markets and low-income communities
- The CDE obtains the tax credit allocation from the CDFI Fund
- The CDE invests the private equity in qualified projects located in LICs
- The CDE manages the investments

Community Development Entity (cont.)

- Responsibilities of the CDE
  - Receives QEIs and invest them into Qualified Active LIC Businesses (QALICBs) through investments called Qualified LIC Investments (QLICIs)
  - Complies with NMTC program regulations
  - Remains in good standing with the CDFI Fund
  - Provides periodic reporting to the CDFI Fund, the IRS and investors

Community Development Entity (cont.)

- Seattle Investment Fund LLC
  - CDE's $40 million NMTC allocation managed by the City of Seattle – Office of Economic Development

Community Development Entity (cont.)

- Seattle Investment Fund LLC
  - Investment Priorities
    - *Geographic Eligibility*: The CDE has made a commitment to the federal government to allocate the bulk of its NMTC allocation in areas with deeper economic distress.

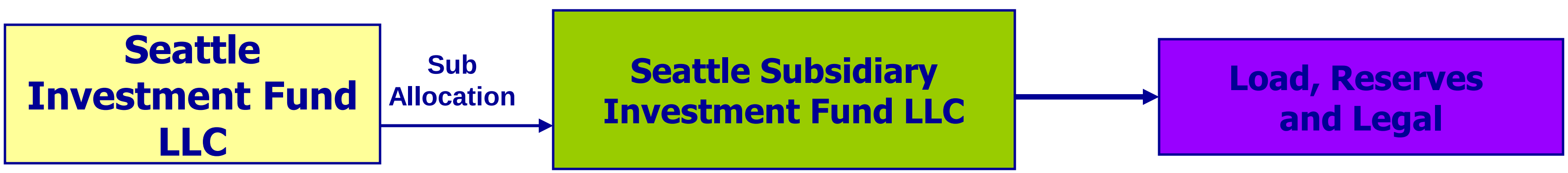
Community Development Entity (cont.)

- Seattle Investment Fund LLC
  - Investment Priorities
    - *Project Readiness*: CDE will not consider project until it has obtained letters of interest from the lenders/NMTC investors needed to finance the transaction.

Community Development Entity (cont.)

- Seattle Investment Fund LLC
  - Investment Priorities
    - *Public Benefits*: Priority will be given to projects that achieve one or more of the following economic development benefits:
      - Create or retain permanent jobs in low-income communities;
      - Increase the availability of goods and services needed by neighborhood;
      - Serve as an anchor for future economic development;
      - Enhance the local tax base through increased sales and/or property taxes;
      - Include energy efficient building or process improvements; and/or
      - Increase the amount of affordable housing (i.e. housing serving households at 50% - 80% of median income)

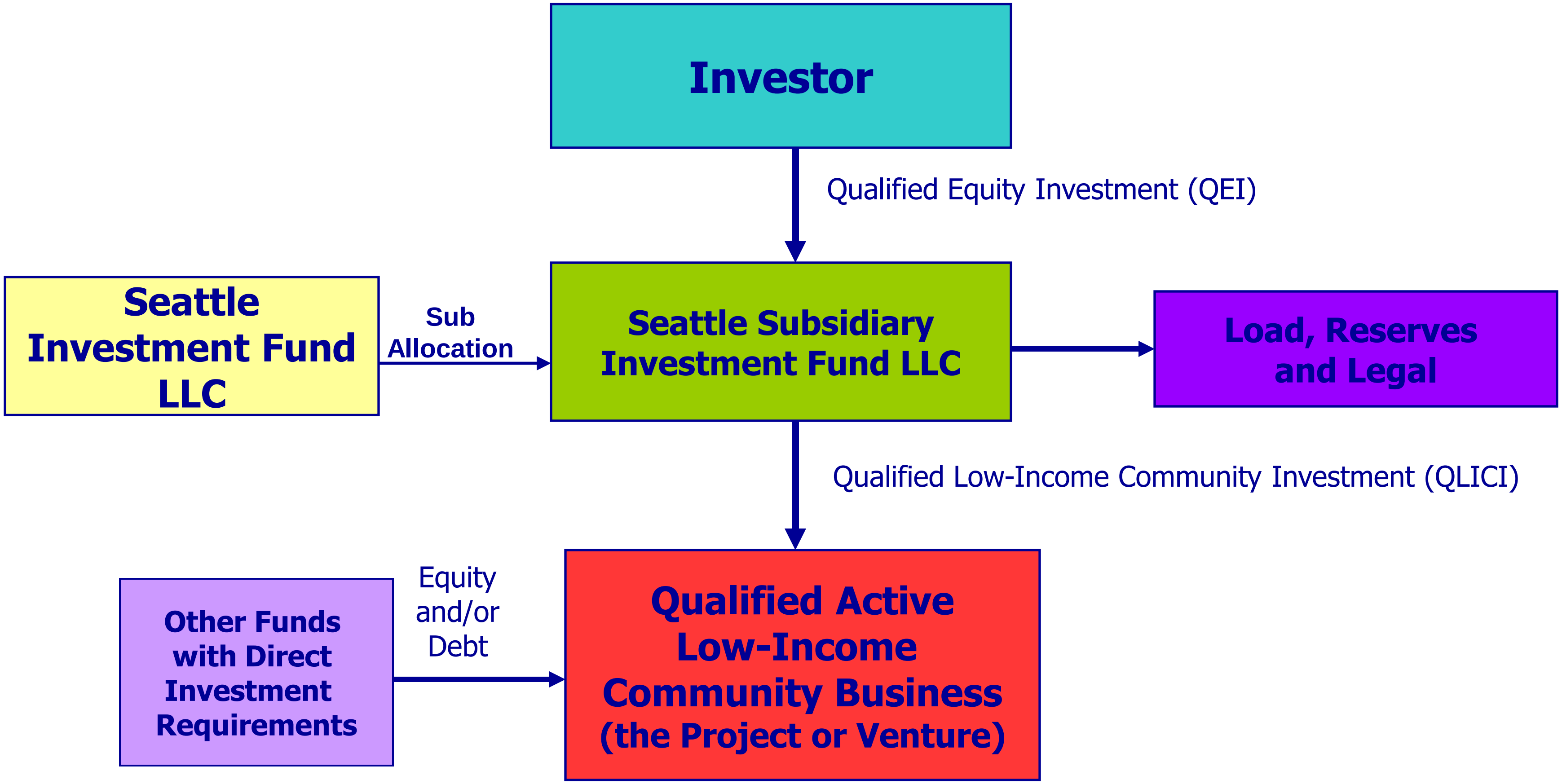
NMTC Flow of Funds



- NMTC = 39% of QEI
- 85% of QLICI must remain invested for seven years

QEI – Investment to CDE

NMTC Basic Flow of Funds



Qualified Equity Investment

- The QEI Is the Amount of Money Invested by the investor into the CDE
  - The QEI is the basis for the amount of tax credits received by the investor
  - The QEI is also the amount of NMTC allocation made from a CDE
  - The source of the QEI could be one or multiple investors

Qualified Equity Investment (cont.)

- The QEI Is Equity — not Debt
  - In order for the QEI to be equity, it must not be debt
  - But an investor can borrow its equity from a third party
  - By IRS definition, equity cannot be collateralized
  - Ergo, the CDE can offer no collateral to the investor or to any lender who finances the investor

Qualified Equity Investment (cont.)

- The QEI Must Remain Outstanding for at least Seven Years
  - The QEI may pay a return on equity, but cannot provide a return of equity

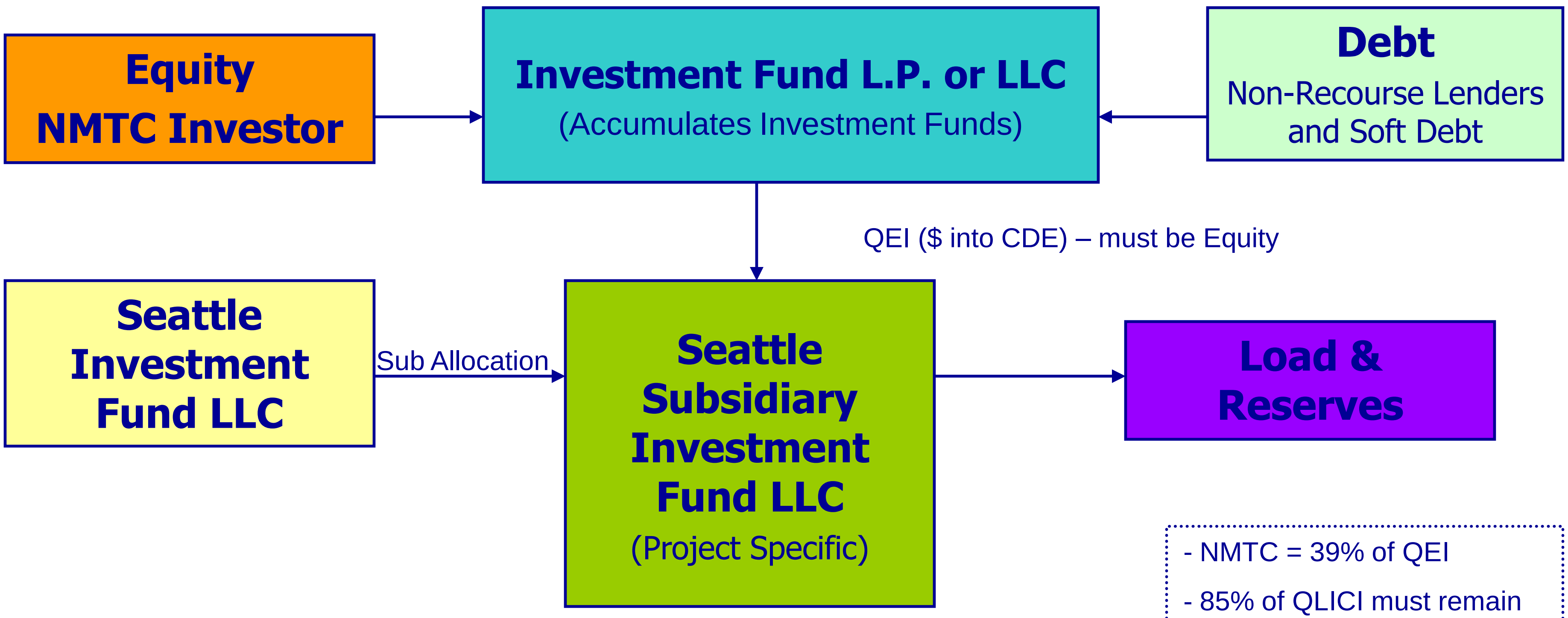
Qualified Equity Investment (cont.)

- When an Investor Borrows to Make an Equity Investment
  - The investor typically forms an upper tier investment fund to accumulate the investment funds which are passed onto the CDE
  - The investment fund will be either a Limited Partner (LP) or Limited Liability Company (LLC) with a General Partner (GP) or managing member

Qualified Equity Investment (cont.)

- The lender lends to the upper tier fund
- The tax credit investor invests its equity as the LP or member of the LLC
- The upper tier investment fund then invests the money into the CDE as the QEI
- Referred to as a leveraged investment

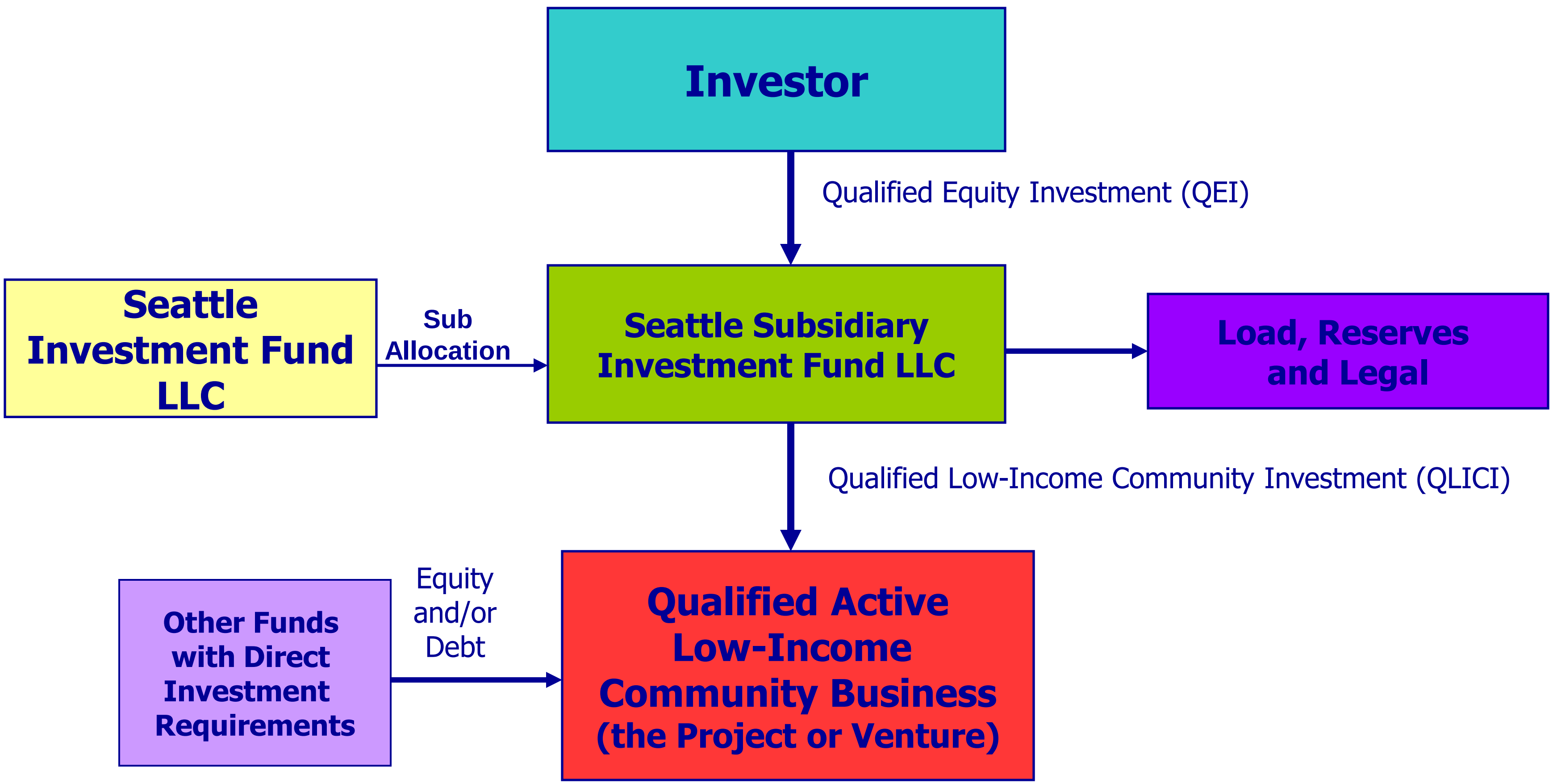
NMTC Flow of Funds



- NMTC = 39% of QEI
- 85% of QLICI must remain invested for seven years

QLICI – Investment to Project

NMTC Basic Flow of Funds



Qualified Active Low-Income Community Business

- The QALICB Is the Recipient of Funds from the CDE
  - The QALICB must have a substantial connection with the community as measured by three tests
    - Tangible Property Test: > 40 percent of the QALICB's tangible property must be located in the LIC
    - Services Test: > 40 percent of the services of the QALICB's employees must be performed in the LIC
    - Gross Income Test: > 50 percent of the QALICB's gross income must be generated from activities performed in the LIC

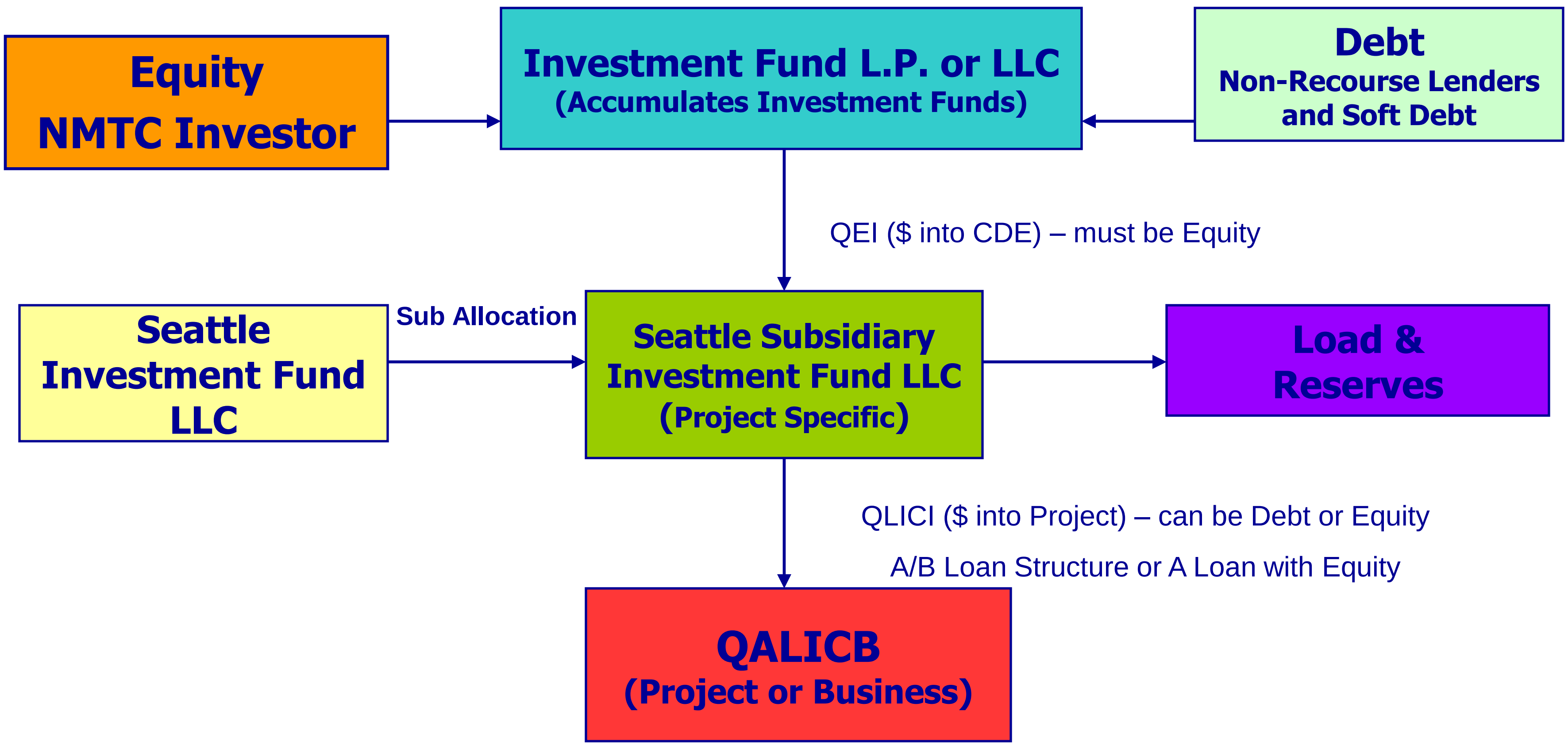
Qualified Low-Income Community Business (cont.)

- These tests can be applied to a business with multiple locations by looking at the facility in the LIC as though it were a stand-alone facility in a separately incorporated business
- Ergo, the NMTC Program is perfectly designed for real estate financing in LICs because the tests will be met almost by definition

Qualified Low-Income Community Business (cont.)

- Two more tests of the QALICB
  - Less than 5.0 percent of the QALICB's assets can be attributed to non-qualified financial instruments. That is, the QALICB cannot be a financial institution or finance company
  - Less than 5.0 percent of the QALICB's assets can be attributed to collectibles unless for sale in the normal course of business

NMTC Flow of Funds



Qualified Low-Income Community Investment

- The Financing from the CDE to the QALICB Is Known as a QLICI
  - A QLICI can be debt or equity or a combination of both

Qualified Low-Income Community Investment (cont.)

- Very Flexible Use of Proceeds
  - Almost any legitimate business use is permitted
  - Can be construction, permanent (must meet "substantial improvement" definition) or bridge financing
  - Can be used for working capital, machinery and equipment (M&E), fixed assets, and even for research and development (R&D) and soft costs
  - But, it must have a term of at least seven years

Unique Loan Features Sought by NMTC Program

- The Loan or Investment Has the Following Characteristics
  - Equity product
  - Equity-equivalent terms and conditions
  - Interest rates 25% to 50% below market or meet a designated number of the following
    - Debt with equity features (i.e., debt with royalties debt with warrants; convertible debt)
    - Subordinated debt
    - Below market interest rates
    - Lower than standard origination fees

Unique Loan Features Sought by NMTC Program (cont.)

- A longer than standard period of interest only loan payment
- Higher than standard loan to value ratio
- A longer than standard amortization period
- More flexible borrower credit standards
- Nontraditional forms of collateral
- Lower than standard debt service coverage ratio or
- Loan loss reserve requirements that are less than standard

Structuring the QLICI

- Passing Benefit to the QALICB
  - The most effective and visible way for the CDE to pass benefit to the QALICB is to leave a portion of the value of the tax credits in the project after giving a market yield to the investor
  - Below market interest rate loans with seven year terms
  - A/B loan where "A" loan matches the leveraged loan and the "B" loan matches the tax credit equity less any fees or set asides held at the CDE. Loan rate and terms are set to ensure timely payments to leveraged lender

Structuring the QLICI (cont.)

- "A" loan with equity contribution
- Forgivable loans will be taxable income to the QALICB
- When taking an equity investment, cannot exceed a 49 percent interest in the QALICB (related party rule) unless allowed as part of your allocation agreement

NMTC Deal Structuring Key Considerations

Investor Pricing and NMTC Fees

- Investor Pricing
  - Current pricing ranges from $0.67 - $0.75 Per Credit

- CDE Fees
  - Current City CDE Fees are :
    - 3% CDE Fee
    - 2.8 Asset Management Fee (40 basis points/year x 7 years)
    - 1.0% Underwriting Fee
    - Annual Third-Party Legal / Audit Costs – approx. $20,000 Per Year

Pricing & Fees - Example

QEI = $10,000,000
NMTC = 39% of QEI or $3,900,000 over 7 years

If investor pricing =$0.67

- Investor contributes $3,900,000 x $0.67 = $2,613,000

▪CDE Fees – 5.8% (CDE + asset management)	$580,000
▪CDE Underwriting Fee – 1% -	$100,000
▪Annual Audits -- $20,000 YR x 7 Years	$140,000

NET NMTC EQUITY TO PROJECT $1,793,000

Compliance and Recapture of Tax Credits

- **Compliance Period**
  - Seven years
- **Recapture Triggers**
  - CDE loses its certification with the CDFI Fund
  - CDE fails to meet the "substantially all" test
  - CDE redeems the QEI
  - The IRS determines that the QALICB, QLICI or QEI fails to meet the intent of the NMTC Program

Compliance and Recapture of Tax Credits (cont.)

- Tax Credit Recapture Risk Is CDE-based
  - Failure to meet its mission of serving low income communities
  - Failure to be accountable to low income communities through Advisory Board
  - Failure to comply with the reporting requirements
  - Therefore, the CDFI Fund selected CDEs that have staying power and are finance-oriented
  - This is unlike LIHTCs and RTCs which have project-based risk

Compliance and Recapture of Tax Credits (cont.)

- Substantially all Test
  - At least 85 percent of the QEI must be continuously invested in QLICI's but also must meet its CDFI Allocation agreement
  - In addition, up to 5.0 percent of the QEI may be held by the CDE as a debt reserve
  - Ergo, only 80 percent of the QEI must be continuously invested in QLICIs
  - Ironically, bankruptcy and/or foreclosure on the project may not violate the 85 percent rule

Compliance and Recapture of Tax Credits (cont.)

- Redeeming the QEI Equity
  - Redeeming the first dollar of QEI during the seven-year compliance period may result in a full recapture of tax credits
  - Care must be taken in structuring the QLICI to insure that up-streamed distributions of cash flow cannot be interpreted as redemption of capital, a return <u>of</u> equity
  - Good tax and legal counsel are essential

Structuring a QEI

- No Repayment of the QEI for Seven Years
  - The very first dollar of repayment of QEI triggers recapture
  - While return of equity (QEI) to the investor is not permitted, return on the QEI is permitted
  - Therefore, all cash flow up-streamed to the investor must be structured as return on equity and will be recognized as income

Structuring a QEI (cont.)

- Collateral and the Upper Tier Lender
  - The QEI is equity – therefore, no collateral can be given to any investor or upper tier lender by the CDE from QALICB assets
  - The upper tier lender may receive collateral outside the New Markets transaction
  - The upper tier lender can receive an assignment of the investor's ownership interest in the CDE
  - To protect the investor, the upper tier lenders may need to agree to forebear on foreclosure during the compliance period

Structuring a QLICI

- The 85 Percent Test
  - At least 85 percent of the QEI must be invested in the QLICI (loans and investments) within 12 months
  - Ergo, the QEI cannot sit around in the CDE indefinitely
  - Reserves cannot be overfunded (e.g., no three years debt service reserves)

Structuring a QLICI (cont.)

- Make Interest-only Loans or Dividend-only Investments
  - The market accepts a complete prohibition on repayment of principal of the QLICI for seven years in order to comply with the substantially all test

Structuring a QLICI (cont.)

- Ergo, the QLICI should be interest only (if debt) or pay dividends only (if equity)
- Alternatively, very modest principal reduction is permitted (85 percent of the QEI must remain invested at all times)
- If the amount of principal collected exceeds 15 percent, the excess must be reinvested within 12 months

Structuring a QLICI (cont.)

- Debt Portion of the QLICI
  - Typically is a loan secured by a mortgage (first or second) or deed of trust and the guarantees of the principals as appropriate
  - Also UCC filings
  - Interest only for seven years
  - Rate will be set to insure adequate interest collections to satisfy the upper tier lender

Structuring a QLICI (cont.)

- Equity Portion of the QLICI
  - May have dividends to provide a return on equity to the investor.

Exiting a Deal

- Timing of Exit
  - At the end of the seven-year compliance period, the CDE will exit the deal
  - The CDE will have assets: the outstanding balance of the QLICI and possibly an equity interest in the QALICB
  - To insure unraveling, there will be both call and put options built into the partnership or LLC agreements

Exiting a Deal (cont.)

- The CDE may dissolve and distribute its assets, the debt portion of the QLICI, to the upper tier entity
- If there is an upper tier investment fund, the investor's interest may be put to the fund manager (the GP or the managing member) or another third party
- If there is an upper tier lender, the loan portion of the QLICI may be assigned to the lender to satisfy its debt

Exiting a Deal (cont.)

- That is, the lender steps into the shoes of the CDE and receives all the collateral securing the CDE for the first seven years
- Documents must be coordinated with the upper tier lender

Exiting a Deal (cont.)

- Equity Portion
  - As stipulated in the QLICI agreements, the CDE may tender the equity portion of the QLICI to the QALICB
  - Alternatively, the CDE may pass the equity portion to the upper tier entity

Exiting a Deal (cont.)

- CDE Dissolution
  - After that, the CDE will dissolve
  - And . . . everyone lives happily ever after . . . .

Hypothetical Investment – Detailed Breakdown

$10 Million Project

Project Needs $10,000,000

In an Eligible Census Tract?

Is It An Eligible Borrower?

- Can be a For-Profit or Non-Profit
- Can Be Real Estate or Business Financing
- Can Be Mixed Use Residential / Commercial IF
  - 25% of Effective Income Is Non-Residential

Does 50% of Sales/ Services and Assets Derive From That Location

If Yes – move ON

$10 Million Project cont.

Project Needs $10,000,000

Investment Also Needs to Include NMTC Costs

Legal / Closing Costs - $250,000
CDE Fees / Audits - $820,000

SO – YOU REALLY NEED $11,070,000
HOW DO WE GET IT?

Where Does Investment Capital Come From?

Investor Who Can Use Federal Credits

Investment Fund Created

Invests $11,070,000 in Seattle CDE
This Is The QEI

Receives $4,317,300 in Tax Credits
Priced at $0.67 - $2,892,591

NMTC = 39% of QEI

Seattle Investment Fund LLC

Sub Allocation

Seattle Subsidiary Investment Fund LLC

Load, Reserves and Legal

Where Does Investment Capital Come From?

Investor Who Can Use Federal Credits

Investment Fund Created
$11,070,000

$2,892,591 Represents Equity Value of Investment Needs NO Further Repayment

Borrows The Balance of Equity $8,177,409

NMTC = 39% of QEI

Seattle Investment Fund LLC

Sub Allocation

Seattle Subsidiary Investment Fund LLC

Load, Reserves and Legal

Issues With Borrowed Funds

Investment Fund Created
$11,070,000

Lender

Seattle Subsidiary Investment Fund LLC

Borrows The Balance of Equity
$8,177,409

Loan Must Be:

-- At Least 7 Year Term
-- Interest-Only with Balloon
-- No Direct Collateral in Borrower Assets

Only Risk Capital In The Investment

Where Does Investment Capital Come From?

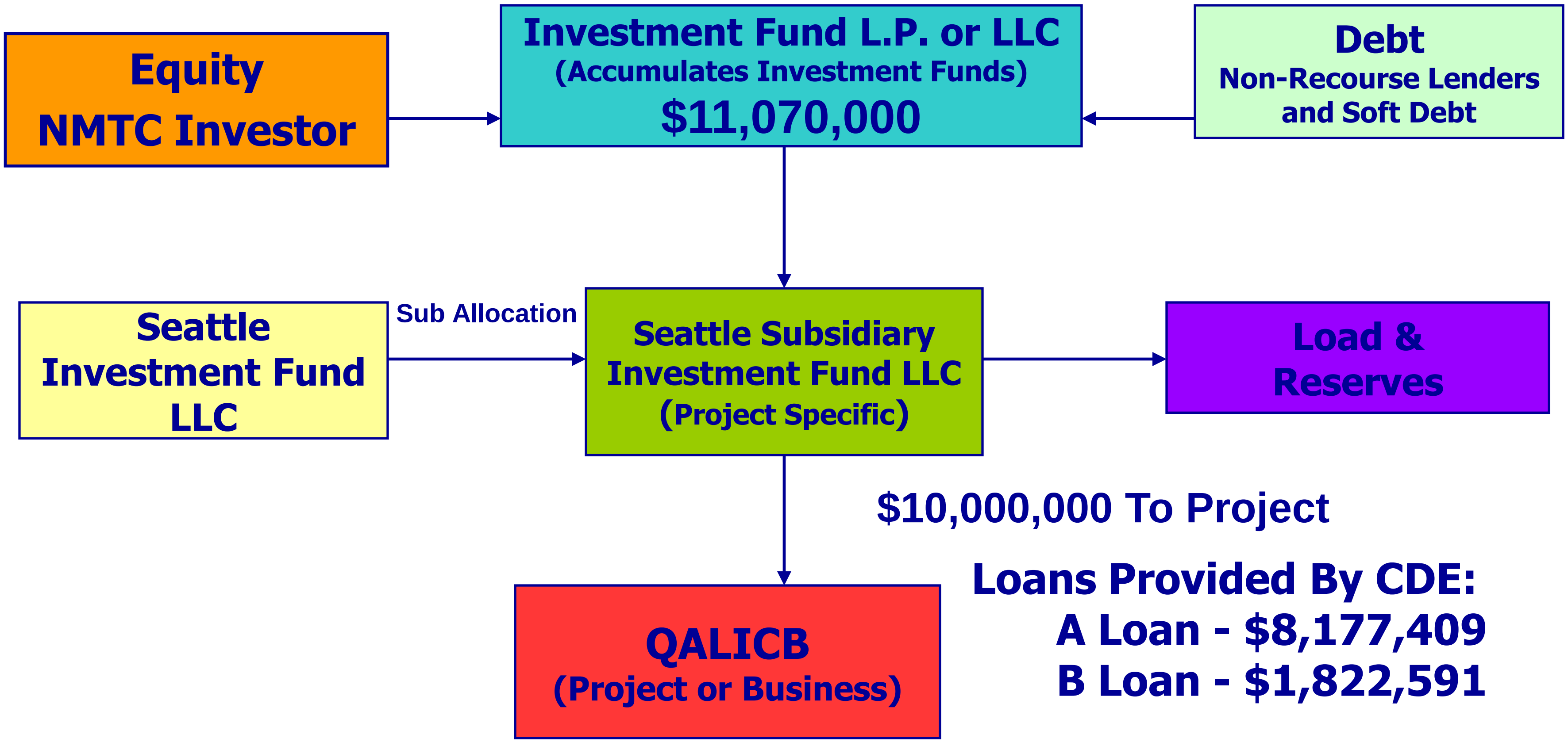
Investment Fund
Created
$11,070,000

**Seattle Subsidiary
Investment Fund LLC**

**Load, Reserves
and Legal**

CDE Keeps $1,070,000 For NMTC Fees and Costs
$10,000,000 Remaining Is Lent To Project

NMTC Final Flow of Funds
How We Got The Project $10,000,000

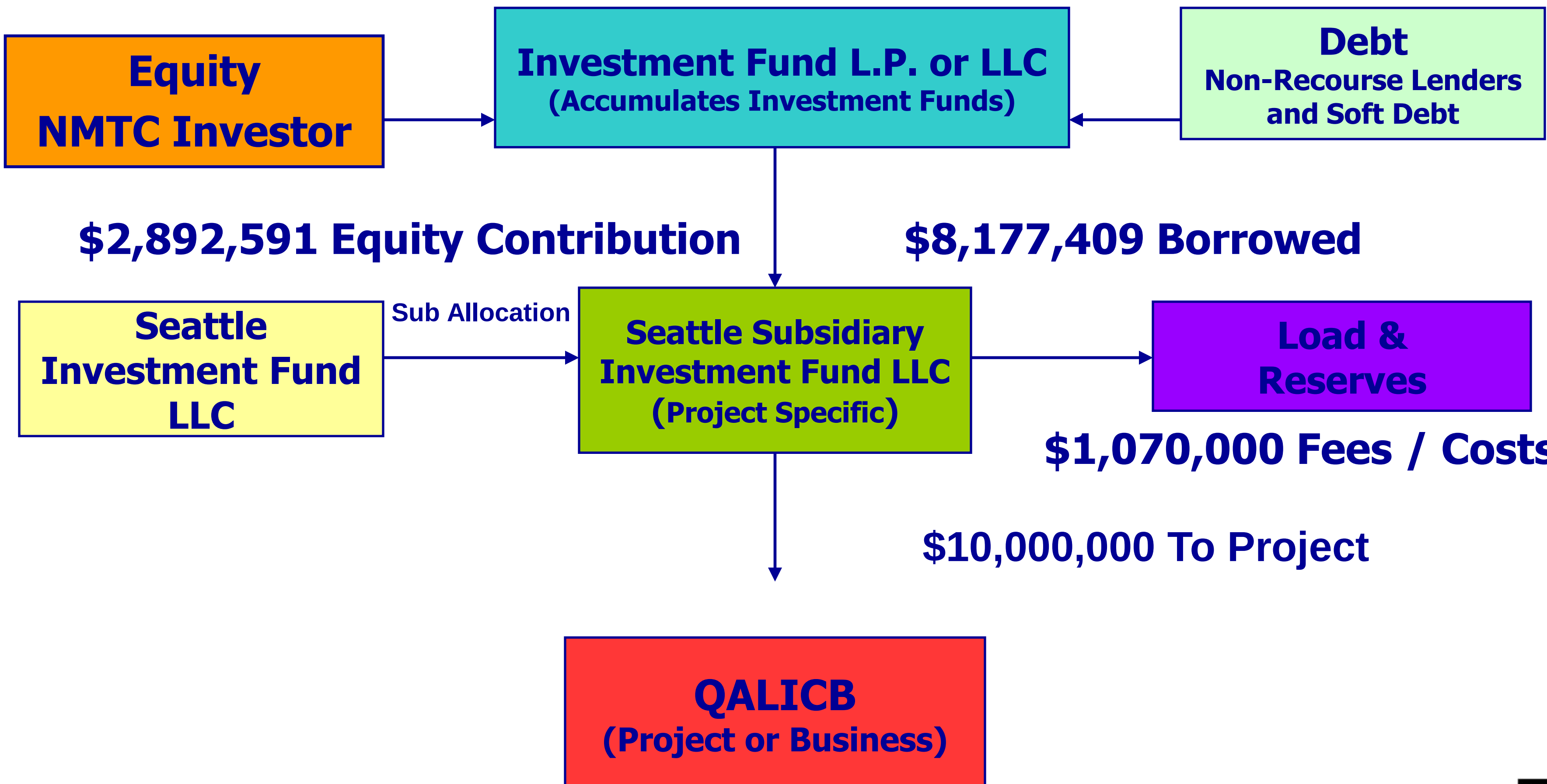


$10,000,000 To Project

Loans Provided By CDE:
- **A Loan - $8,177,409**
- **B Loan - $1,822,591**

B Loan Is Permanent Equity

NMTC Final Flow of Funds
How We Got The Project $10,000,000



FINAL INVESTMENT BENEFIT

Project Needs $10,000,000

CDE PROVIDES $10,000,000 IN LOANS

INVESTMENT STRUCTURE REQUIRES $8,177,409 IN DEBT

- CAN COME FROM BANK LENDER
- CAN COME FROM CITY LOAN PROGRAMS
- CAN COME FROM OWNER EQUITY

PROJECT GETS $10,000,000 – ONLY BORROWS $8,177,409

$1,822,591 (18%) COMES FROM NMTC EQUITY

New Markets Tax Credits
ISSUES TO PAY ATTENTION TO

- Investor equity and investor debt have different risk concerns:
- Equity investor is concerned about recapture so they focus on making sure the CDE stays in the deal and any default proceeds are not returned to the lender. They require any lender to forbear their rights to foreclose on investment debt.
- Debt lender wants to be able to access the assets if they don't get paid. To be qualified debt – their loan:
  - Can only have an interest in the partnership – not typical collateral – so they are basically unsecured
  - Typically have interest-only terms during NMTC period so there isn't any loan amortization
- Typical responses:
  - Have the same equity investor and investment lender. Limits who can do deals.
  - OR have "soft" public debt AND Owner Equity to reduce lender risks

New Markets Tax Credits
ISSUES cont.

- **Additional lender issues - NMTC transactions want to close at construction to bring the value of the NMTC into the construction phase.**
- **Brings ALL construction lender risks into play:**
  - Development Budget Accuracy
  - General contractor experience
  - Construction schedule
  - GENEROUS CONTINGENCIES
- **Since many NMTC lenders think like permanent lenders, you may have issues in closing for construction.**

New Markets Tax Credits
ISSUES cont.

- **Financial Underwriting**

  - In the end, NMTCs are underwriting as a permanent lender to projects. So strong operating performance is essential.

  This is due to one of the few NMTC recapture concerns:

- **NMTC Recapture. If:**
  - CDE ceases to be a CDE; or
  - CDE doesn't continually invest and reinvest at least 85% of investment; or
  - CDE redeems the investment.

The last event may happen in case of default. If the project goes into receivership and is liquidated, the CDE CANNOT return those proceeds to the investor. They must be reinvested in another eligible project.

Contacts

- **For more information:**

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